

# Tax Benefits For Education

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## Abstract

*The past eight years have been a time of great change in the tax treatment of higher education expenses. The Taxpayer Relief Act of 1997 started this process with the creation of the HOPE Scholarship and Lifetime Learning Credits. The subsequent Economic Growth and Tax Relief Reconciliation Act of 2001 expanded these incentives, but these provisions will terminate at the end of 2010 unless new legislation extends them. This article provides an overview of determining eligibility for education credits and computation thereof, discussion of the deductibility of student loan interest, eligibility for tuition and fees deduction, and comparison of credits versus deductions in terms of which one is more beneficial to a particular taxpayer.*

## INTRODUCTION

Congress has generally used tax credits to achieve social or economic objectives to promote equity among different types of taxpayers. The federal government offers several tax benefits and advantages for investing in or pursuing a college education. These tax benefits started on August 5, 1997 when both the Balanced Budget Act of 1997 and the Taxpayer Relief Act of 1997 were enacted. The Taxpayer Relief Act of 1997 provides for the HOPE Scholarship and Lifetime Learning Credits and opens the doors of college to a new generation, with the largest investment in higher education since the G.I. Bill 50 years ago.<sup>1</sup>

A credit is a direct reduction in tax liability instead of a deduction from income. Tax credits are used because they can target tax relief to certain groups of taxpayers. Because of the progressive rate structure of the income tax, a deduction provides greater benefit to higher income taxpayers, while a tax credit accommodates equal benefits, regardless of the taxpayer's level of income.<sup>2</sup> These tax provisions can be justified under the categories of economic, social, equity, and political considerations. No one can take issue with the conclusion that a better educated workforce has a positive economic and social impact on our society, as well as increased tax payments for the government.

The objectives of this paper are: (a) to determine eligibility for the education credits and compute the potential credits, (b) to determine whether a taxpayer has paid deductible student loan interest and compute the deduction, (c) to decide whether the credit or the deduction is more advantageous based on individual's circumstances, (d) to determine eligibility for the tuition and fees deduction and compute the potential deductions, and (e) to make recommendations concerning which one of these educational tax benefits is more beneficial to a particular taxpayer.

The Taxpayer Relief Act of 1997 and the subsequent Economic Growth and Tax Relief Reconciliation Act of 2001 have created a number of incentives to help taxpayers save for higher education expenses. However, all the provisions of this act will "sunset" on December 31, 2010 unless new legislation extends them. The following is a brief description of the conditions and criteria of the credits, the loan deduction, and other educational tax incentives.

<sup>1</sup> Hoffman, W.H., Smith, J.E. & Willis, E., *Individual Income Taxes*, 2005 Edition, (Thompson/Southwestern Publishing Co. 2005), PP.13-3--4

<sup>2</sup> Wittenburg, G.E. and M. Altus-Buller, *Income Tax Fundamentals*, 2005 Edition, (Thompson/Southwestern Publishing Co. 2005), P. 6-1

## **TAX CREDITS**

Parents sending children to college or adults continuing their education may be eligible for the HOPE Scholarship tax credit or the Lifetime Learning tax credit for higher education expenses paid through 12/31/2010.

The Hope Scholarship is a tax credit, not a scholarship. Tax credits are subtracted from the tax that a taxpayer owes, rather than deducting them from taxable income like a tax deduction. The taxpayer must file a federal tax return and owe taxes to get this tax credit. The taxpayer cannot get a refund for the HOPE tax credit if the taxpayer does not pay taxes. If the taxpayer owes less in taxes than the maximum amount of the HOPE tax credit, which is \$1,500, for which the taxpayer is eligible, the taxpayer can only take the credit for the amount the taxpayer owes in taxes (e.g. if the taxpayer's tax liability is only \$700, his HOPE tax credit is limited to \$700).

The HOPE Credit covers the first two years of a post-secondary program leading to a degree or certificate. Parents of dependent students or independent students who are not claimed as an exemption on their parents' tax return may qualify for a HOPE tax credit of up to \$1,500 per student per year for tuition and related educational expenses. The credit can only be taken on the tax return claiming the exemption for the student.

The HOPE Credit is calculated on 100% of the first \$1,000 you spend on tuition and fees required for enrollment and attendance (not room and board, books and supplies, or travel) and 50% of the next \$1,000 during the applicable tax year to an institution that participates in the U.S. Department of Education student aid program. Therefore, \$1,500 is the maximum credit.

To qualify for the HOPE Credit, the student must have earned a high school diploma or equivalent degree, be enrolled at least half time for one academic period during the tax year, and not have been convicted of a federal or state drug felony. The Hope Credit is available to individuals with modified adjusted Income (MAGI) under \$53,000 for a single or head of household taxpayer (phasing out between \$43,000 and \$53,000), or under \$107,000 for joint filers (phasing out between \$87,000 and \$107,000). The phase-out amounts are for 2005<sup>3</sup>.

The taxpayer, the taxpayer's spouse, and the taxpayer's dependent(s) are eligible for the Hope credit. To qualify for the tax credit, the taxpayer must not be claimed as an exemption on another person's tax return or have a tax filing status of married filing separately. Furthermore, you cannot combine the HOPE Credit with other education tax benefits--such as the Lifetime Learning Credit or tuition and fees deduction--in the same year for the same qualifying person.

The Lifetime Learning tax credit is available to individuals who file a tax return and owe taxes. This is a tax credit which means the amount of the credit is subtracted from the taxes your family owes, instead of subtracting them from taxable income like a tax deduction. If your family owes less in taxes than the amount of the Lifetime Learning tax credit for which your family is eligible, you can only take the credit for the amount you owe in taxes. It is, therefore, called a nonrefundable tax credit.

Your family may claim a Life-Time Learning Credit (LLC) of up to \$2,000 per year, which is 20% of \$10,000 as of 1/1/2004 for the taxpayer, taxpayer's spouse, or any eligible dependents for an unlimited number of tax years. The Lifetime Learning credit is available for years of postsecondary education and for courses to acquire or improve job skills. Unlike the HOPE credit (which is only available for two years) the Lifetime Learning credit is available for an unlimited number of years. This credit is family-based (up to \$2,000 per tax return) rather than based on the number of qualifying individuals in your family as with the HOPE credit.

The Lifetime Learning credit is available to individuals with modified adjusted income (MAGI) under \$53,000 for a single taxpayer and head of household filers (phasing out between \$43,000 and \$53,000), or under \$107,000 for joint filers (phasing out between \$87,000 and \$107,000). The taxpayer must claim the eligible student as a dependent unless the credit is for the taxpayer or the taxpayer's spouse. These rules are similar to the HOPE credit.

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<sup>3</sup> Hoffman, W.H., Smith, J.E. & Willis, E, *Individual Income Taxes*, 2006 Edition, (Thompson/Southwestern Publishing Co. 2006), P.13-24

**TAX DEDUCTIONS**

The following tax deductions such as student loan interest and tuition and fees will be discussed briefly in this paper.

Taxpayers who have taken loans to finance an education at an eligible institution (a university, college, vocational school, or other post-secondary school that is qualified to participate in federal student aid programs) may be qualified to deduct some of the interest they pay on loans for themselves, their spouse or dependent. The taxpayers do not need to itemize their deductions to claim this deduction. The maximum deductible amount of interest is \$2,500 for years beginning in 2001 and thereafter. However, the Tax Relief Act of 2001 increases the modified adjusted gross income in 2005 for the taxpayers who are eligible for the student loan interest deduction for single and head of household filers under \$69,700 and for married taxpayers filing jointly with an income under \$139,400.

The taxpayers who do not qualify because of the modified adjusted gross income phase-outs should consider having their children borrow the funds. The following loans may be eligible for the deduction:

- Federal Stafford loans
- Federal PLUS Loans (Parent)
- Federal Consolidation Loans
- Federal Perkins Loans
- Alternative Education Loans (issued by government, banks, private lenders or school specifically for education expenses)

The student must be enrolled at least halftime in an eligible institution. Expenses that are eligible for loans include tuition, fees, books, room and board, supplies, transportation, and other related educational expenses.

Tuition and fees deduction is another higher education tax benefit which was introduced in 2002. It currently allows eligible taxpayers to deduct up to \$4,000 from their AGI for qualified education expenses paid on behalf of the taxpayer, the taxpayer's spouse or a dependent. Moreover, it is not necessary to itemize these deductions on their tax return. (They are deductible even if the taxpayer takes the standard deduction.)

This tax benefit is available for single and head of household tax filers with MAGIs up to \$80,000 and married filing jointly filers with MAGIs up to \$160,000. The taxpayers cannot use this deduction if the taxpayers claimed a tax credit for education expenses for the same student in the same year. This deduction can be claimed in place of the HOPE or Lifetime Learning credit. The deduction is especially beneficial for taxpayers whose MAGIs are too high to qualify for those credits. The deduction is scheduled to end after 2005. The tuition and fees deduction is available for the years of postsecondary education and for courses to acquire or improve job skills.

**REPORTING REQUIREMENT**

To apply for the credit, the taxpayer must report the amount of tuition and fees paid as well as the amount of certain scholarships, grants, and untaxed income used for the tuition and fees. The law specifies that universities and colleges will forward the taxpayers this information in the form of a 1098-T statement and also to the Internal Revenue Service. Furthermore, the taxpayers must be aware that they are restricted from receiving a double tax benefit associated with qualifying educational expenses. Therefore, the taxpayers who claim an education tax credit may not deduct the expenses, nor may they claim the credit for the amounts that are otherwise excluded from gross income (for example, tax-free scholarships, grant, and employer-paid educational assistance).<sup>4</sup> Furthermore, the taxpayers cannot double-dip, meaning that if the interest is deductible elsewhere on the return (e.g., home mortgage interest), the taxpayers cannot also deduct it as student loan interest.

A college or university that received qualified tuition and related expenses from a taxpayer is required to file Form 1098-T with the IRS. A copy of Form 1098-T must be furnished to the taxpayer as well. The information being reported to the IRS verifies student enrollment with regard to certain eligibility criteria for the HOPE Tax Credit, the Lifetime Learning Tax Credit, and the Higher Education Tuition and Fees-Deduction. However, the enrollment information by itself does not establish eligibility for either credits or deductions.

## CONCLUSIONS:

The following chart is a summary which will help taxpayers allocate their qualified education expenses in a way that may maximize the taxpayers' total education tax benefits.

- Since the Hope Scholarship is a tax credit of at least 50% of the amount of the expenses, it is better than the tax deductions and exclusions from income.
- Since the Lifetime Learning tax credit is 20% of the amount of the expenses, whether it is better than tax deductions and exclusions from income depends upon your tax bracket. If your tax bracket is less than 20%, then the Lifetime Learning tax credit is better than the tax deductions and exclusions from income. If your marginal tax rate is higher than 20%, you cannot assume the deduction is more beneficial because the LLC is based on expenses up to \$10,000 versus a deduction limit of \$4,000.
- However, the tuition and fees deduction is taken as an adjustment to gross income. Since this reduces the adjusted gross income, it can potentially make the taxpayer eligible for additional financial aid next year. If that aid is in the form of grants instead of loans, it can potentially make the tuition and fees deduction more attractive than the Hope Scholarship or Lifetime Learning tax credit.

In short, there are other tax benefits programs such as: 529 plans, Coverdell Education Savings Accounts, savings bonds, and Tax-Free Employer Educational Assistance, all of which are the subject of another study

## Tax Benefits for Higher Education Expenses Summary of Basic Characteristics for Tax Year 2005

Provision:	HOPE Credit	Lifetime Learning Credit	Deductions for Higher Education Expenses	Student Loan Interest Deduction
<b>Tax benefit</b>	100% credit for first \$1,000 of expenses; 50% for next \$1,000 (\$1,500 Max. per student)	20% of first \$10,000 (\$2,000 Max. per family)	\$4,000 Max. per year	\$2,500 Max. per year
<b>Taxpayer Eligibility</b>	Taxpayer, spouse & dependents	Taxpayer, spouse & dependents	Taxpayer, spouse & dependents	Taxpayer, spouse & dependents
<b>Educational Eligibility</b>	First 2 years of undergraduate postsecondary education	Any undergraduate, graduate, professional study, or Vocational study	Any undergraduate, graduate, or professional study. Student must have a high school diploma	Any undergraduate, graduate, or professional study
<b>Qualifying Expenses</b>	Tuition & fees	Tuition & fees	Tuition & fees	Tuition, fees, room & board, books, supplies & other educational expenses
<b>Income Limits</b>	\$53,500 for single and head of household filers; \$107,000 for married joint filers	\$53,500 for single and head of household filers; \$107,000 for married joint filers	\$80,000 for single and head of household filers; \$160,000 for married joint filers	\$69,700 for single and head of household filers; \$139,400 for married joint filers
<b>Student's Enrollment Status</b>	At least half-time in a degree granting undergraduate program	At least one postsecondary course	At least one postsecondary course	At least half-time when loans used
<b>Limitations</b>	Can not also claim Lifetime Learning; No felony drug convictions	Cannot also claim HOPE credit	In effect for 2002 to 2005 only	None
<b>Effective date</b>	1/1/1998	7/1/1998	1/1/2002	1/1/1998

**REFERENCES**

1. Hoffman, W.H., Smith, J.E., & Willis, E, *Individual Income Taxes*, 2005 Edition, (Thompson/Southwestern Publishing Co.2005), P.13-26
2. Hoffman, W.H., Smith, J.E., & Willis, E, *Individual Income Taxes*, 2006 Edition, (Thompson/Southwestern Publishing Co.2006), P.13-24
3. IRS Codes: Sec.25A (a-b)—The Hope Scholarship Credit; Sec.25A(c-d) --Lifetime Learning Credit; Sec. 25(f-h) --Qualified Tuition and Related Expenses, June 2002
4. IRS Publication 970---Tax Benefits for Higher Education, 2004, PP. 8-45
5. Wittenburg, G.E. and M.Altus-Buller, *Income Tax Fundamentals*, 2005 Edition, (Thompson/Southwestern Publishing Co.2005), P. 6-1

**NOTES**